

loss would have been treated as effectively connected with the conduct of a trade or business in the United States if such income or gain had been received or accrued, or such loss had been sustained, in an earlier taxable year when the taxpayer was engaged in a trade or business in the United States. In applying §§ 1.864-4 through 1.864-7 and this section, the determination whether an item of income, gain, or loss is effectively connected with the conduct of a trade or business in the United States shall not be controlled by any administrative, judicial, or other interpretation made under the laws of any foreign country.

(b) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. During 1967 foreign corporation N, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling household equipment on the installment plan. During 1967 N is engaged in business in the United States by reason of the sales activities it carries on in the United States for the purpose of selling therein some of the equipment which it has purchased. During 1967 N receives installment payments of \$800,000 on sales it makes that year in the United States, and the income from sources within the United States for 1967 attributable to such payments is \$200,000. By reason of section 864(c)(3) and paragraph (b) of § 1.864-4 this income of \$200,000 is effectively connected for 1967 with the conduct of a trade or business in the United States by N. In December of 1967, N discontinues its efforts to make any further sales of household equipment in the United States, and at no time during 1968 is N engaged in a trade or business in the United States. During 1968 N receives installment payments of \$500,000 on the sales it made in the United States during 1967, and the income from sources within the United States for 1968 attributable to such payments is \$125,000. By reason of section 864(c)(1)(B) and this section, this income of \$125,000 is not effectively connected for 1968 with the conduct of a trade or business in the United States by N, even though such amount, if it had been received by N during 1967, would have been effectively connected for 1967 with the conduct of a trade or business in the United States by that corporation.

Example 2. R, a foreign holding company, owns all of the voting stock in five corporations, two of which are domestic corporations. All of the subsidiary corporations are engaged in the active conduct of a trade or business. R has an office in the United States where its chief executive officer, who is also

the chief executive officer of one of the domestic corporations, spends a substantial portion of the taxable year supervising R's investment in its operating subsidiaries and performing his function as chief executive officer of the domestic operating subsidiary. R is not considered to be engaged in a trade or business in the United States during the taxable year by reason of the activities carried on in the United States by its chief executive officer in the supervision of its investment in its operating subsidiary corporations. Accordingly, the dividends from sources within the United States received by R during the taxable year from its domestic subsidiary corporations are not effectively connected for that year with the conduct of a trade or business in the United States by R.

Example 3. During the months of June through December 1971, B, a nonresident alien individual who uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting, is employed in the United States by domestic corporation M for a salary of \$2,000 per month, payable semimonthly. During 1971, B receives from M salary payments totaling \$13,000, all of which income by reason of section 864(c)(2) and paragraph (c)(6)(ii) of § 1.864-4, is effectively connected for 1971 with the conduct of a trade or business in the United States by B. On December 31, 1971, B terminates his employment with M and departs from the United States. At no time during 1972 is B engaged in a trade or business in the United States. In January of 1972, B receives from M salary of \$1,000 for the last half of December 1971, and a bonus of \$1,000 in consideration of the services B performed in the United States during 1971 for that corporation. By reason of section 864(c)(1)(B) and this section, the \$2,000 received by B during 1972 from sources within the United States is not effectively connected for that year with the conduct of a trade or business in the United States, even though such amount, if it had been received by B during 1971, would have been effectively connected for 1971 with the conduct of a trade or business in the United States by B.

[T.D. 7216, 37 FR 23424, Nov. 3, 1972]

§ 1.864-4 U.S. source income effectively connected with U.S. business.

(a) *In general.* This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person from sources within the United States. If the income, gain, or loss of such person for the taxable year

from sources within the United States consists of (1) gain or loss from the sale or exchange of capital assets or (2) fixed or determinable annual or periodical gains, profits, and income or certain other gains described in section 871(a)(1) or 881(a), certain factors must be taken into account, as prescribed by section 864(c)(2) and paragraph (c) of this section, in order to determine whether the income, gain, or loss is effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. All other income, gain, or loss of such person for the taxable year from sources within the United States shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that person, as prescribed by section 864(c)(3) and paragraph (b) of this section.

(b) *Income other than fixed or determinable income and capital gains.* All income, gain, or loss for the taxable year derived by a nonresident alien individual or foreign corporation engaged in a trade or business in the United States from sources within the United States which does not consist of income, gain, or loss described in section 871(a)(1) or 881(a), or of gain or loss from the sale or exchange of capital assets, shall, for purposes of paragraph (a) of this section, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States. This income, gain, or loss shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, whether or not the income, gain, or loss is derived from the trade or business being carried on in the United States during the taxable year. The application of this paragraph may be illustrated by the following examples:

Example 1. M, a foreign corporation which uses the calendar year as the taxable year, is engaged in the business of manufacturing machine tools in a foreign country. It establishes a branch office in the United States during 1968 which solicits orders from customers in the United States for the machine tools manufactured by that corporation. All negotiations with respect to such sales are carried on in the United States. By reason of its activity in the United States M is en-

gaged in business in the United States during 1968. The income or loss from sources within the United States from such sales during 1968 is treated as effectively connected for that year with the conduct of a business in the United States by M. Occasionally, during 1968 the customers in the United States write directly to the home office of M, and the home office makes sales directly to such customers without routing the transactions through its branch office in the United States. The income or loss from sources within the United States for 1968 from these occasional direct sales by the home office is also treated as effectively connected for that year with the conduct of a business in the United States by M.

Example 2. The facts are the same as in example 1 except that during 1967 M was also engaged in the business of purchasing and selling office machines and that it used the installment method of accounting for the sales made in this separate business. During 1967 M was engaged in business in the United States by reason of the sales activities it carried on in the United States for the purpose of selling therein a number of the office machines which it had purchased. Although M discontinued this business activity in the United States in December of 1967, it received in 1968 some installment payments on the sales which it had made in the United States during 1967. The income of M for 1968 from sources within the United States which is attributable to such installment payments is effectively connected for 1968 with the conduct of a business in the United States, even though such income is not connected with the business carried on in the United States during 1968 through its sales office located in the United States for the solicitation of orders for the machine tools it manufactures.

Example 3. Foreign corporation S, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling electronic equipment. The home office of such corporation is also engaged in the business of purchasing and selling vintage wines. During 1968, S establishes a branch office in the United States to sell electronic equipment to customers, some of whom are located in the United States and the balance, in foreign countries. This branch office is not equipped to sell, and does not participate in sales of, wine purchased by the home office. Negotiations for the sales of the electronic equipment take place in the United States. By reason of the activity of its branch office in the United States, S is engaged in business in the United States during 1968. As a result of advertisements which the home office of S places in periodicals sold in the United States, customers in the United States frequently place orders for the purchase of wines with the home office in the foreign country, and the home office makes

sales of wine in 1968 directly to such customers without routing the transactions through its branch office in the United States. The income or loss from sources within the United States for 1968 from sales of electronic equipment by the branch office, together with the income or loss from sources within the United States for that year from sales of wine by the home office, is treated as effectively connected for that year with the conduct of a business in the United States by S.

(c) *Fixed or determinable income and capital gains*—(1) *Principal factors to be taken into account*—(i) *In general*. In determining for purposes of paragraph (a) of this section whether any income for the taxable year from sources within the United States which is described in section 871(a)(1) or 881(a), relating to fixed or determinable annual or periodical gains, profits, and income and certain other gains, or whether gain or loss from sources within the United States for the taxable year from the sale or exchange of capital assets, is effectively connected for the taxable year with the conduct of a trade or business in the United States, the principal tests to be applied are (a) the asset-use test, that is, whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of the trade or business in the United States, and (b) the business-activities test, that is, whether the activities of the trade or business conducted in the United States were a material factor in the realization of the income, gain, or loss.

(ii) *Special rule relating to interest on certain deposits*. For purposes of determining under section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before January 1, 1976) whether the interest described therein is effectively connected for the taxable year with the conduct of a trade or business in the United States, such interest shall be treated as income from sources within the United States for purposes of applying this paragraph and § 1.864-5. If by reason of the application of this paragraph such interest is determined to be income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States, it shall then be treated

as interest from sources without the United States which is not subject to the application of § 1.864-5.

(2) *Application of the asset-use test*—(i) *In general*. For purposes of subparagraph (1) of this paragraph, the asset-use test ordinarily shall apply in making a determination with respect to income, gain, or loss of a passive type where the trade or business activities as such do not give rise directly to the realization of the income, gain, or loss. However, even in the case of such income, gain, or loss, any activities of the trade or business which materially contribute to the realization of such income, gain, or loss shall also be taken into account as a factor in determining whether the income, gain, or loss is effectively connected with the conduct of a trade or business in the United States. The asset-use test is of primary significance where, for example, interest income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States. See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

(ii) *Cases where applicable*. Ordinarily, an asset shall be treated as used in, or held for use in, the conduct of a trade or business in the United States if the asset is—

(a) Held for the principal purpose of promoting the present conduct of the trade or business in the United States; or

(b) Acquired and held in the ordinary course of the trade or business conducted in the United States, as, for example, in the case of an account or note receivable arising from that trade or business; or

(c) Otherwise held in a direct relationship to the trade or business conducted in the United States, as determined under paragraph (c)(2)(iv) of this section.

(iii) *Application of asset-use test to stock*—(a) *In general*. Except as provided in paragraph (c)(2)(iii)(b) of this section, stock of a corporation (whether domestic or foreign) shall not be treated as an asset used in, or held for use

in, the conduct of a trade or business in the United States.

(b) *Stock held by foreign insurance companies.* This paragraph (c)(2)(iii) shall not apply to stock of a corporation (whether domestic or foreign) held by a foreign insurance company unless the foreign insurance company owns 10 percent or more of the total voting power or value of all classes of stock of such corporation. For purposes of this section, section 318(a) shall be applied in determining ownership, except that in applying section 318(a)(2)(C), the phrase “10 percent” is used instead of the phrase “50 percent.”

(iv) *Direct relationship between holding of asset and trade or business—(a) In general.* In determining whether an asset is held in a direct relationship to the trade or business conducted in the United States, principal consideration shall be given to whether the asset is needed in that trade or business. An asset shall be considered needed in a trade or business, for this purpose, only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business conducted in the United States if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset shall be considered as not needed in the trade or business conducted in the United States if, for example, the asset is held for the purpose of providing for (1) future diversification into a new trade or business, (2) expansion of trade or business activities conducted outside of the United States, (3) future plant replacement, or (4) future business contingencies.

(b) *Presumption of direct relationship.* Generally, an asset will be treated as held in a direct relationship to the trade or business if (1) the asset was acquired with funds generated by that trade or business, (2) the income from the asset is retained or reinvested in that trade or business, and (3) personnel who are present in the United States and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset.

(v) *Illustration.* The application of paragraph (iv) may be illustrated by the following examples:

Example 1. M, a foreign corporation which uses the calendar year as the taxable year, is engaged in industrial manufacturing in a foreign country. M maintains a branch in the United States which acts as importer and distributor of the merchandise it manufactures abroad; by reason of these branch activities. M is engaged in business in the United States during 1968. The branch in the United States is required to hold a large current cash balance for business purposes, but the amount of the cash balance so required varies because of the fluctuating seasonal nature of the branch's business. During 1968 at a time when large cash balances are not required the branch invests the surplus amount in U.S. Treasury bills. Since these Treasury bills are held to meet the present needs of the business conducted in the United States they are held in a direct relationship to that business, and the interest for 1968 on these bills is effectively connected for that year with the conduct of the business in the United States by M.

Example 2. Foreign corporation M, which uses the calendar year as the taxable year, has a branch office in the United States where it sells to customers located in the United States various products which are manufactured by that corporation in a foreign country. By reason of this activity M is engaged in business in the United States during 1997. The U.S. branch establishes in 1997 a fund to which are periodically credited various amounts which are derived from the business carried on at such branch. The amounts in this fund are invested in various securities issued by domestic corporations by the managing officers of the U.S. branch, who have the responsibility for maintaining proper investment diversification and investment of the fund. During 1997, the branch office derives from sources within the United States interest on these securities, and gains and losses resulting from the sale or exchange of such securities. Since the securities were acquired with amounts generated by the business conducted in the United States, the interest is retained in that business, and the portfolio is managed by personnel actively involved in the conduct of that business, the securities are presumed under paragraph (c)(2)(iv)(b) of this section to be held in a direct relationship to that business. However, M is able to rebut this presumption by demonstrating that the fund was established to carry out a program of future expansion and not to meet the present needs of the business conducted in the United States. Consequently, the income, gains, and losses from the securities for 1997 are not effectively connected for that year

with the conduct of a trade or business in the United States by M.

(3) *Application of the business-activities test*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the business-activities test shall ordinarily apply in making a determination with respect to income, gain, or loss which, even though generally of the passive type, arises directly from the active conduct of the taxpayer's trade or business in the United States. The business-activities test is of primary significance, for example, where (a) dividends or interest are derived by a dealer in stocks or securities, (b) gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company, (c) royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or (d) service fees are derived in the active conduct of a servicing business. In applying the business-activities test, activities relating to the management of investment portfolios shall not be treated as activities of the trade or business conducted in the United States unless the maintenance of the investments constitutes the principal activity of that trade or business. See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

(ii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example 1. Foreign corporation S is a foreign investment company organized for the purpose of investing in stocks and securities. S is not a personal holding company or a corporation which would be a personal holding company but for section 542(c)(7) or 543(b)(1)(C). Its investment portfolios consist of common stocks issued by both foreign and domestic corporations and a substantial amount of high grade bonds. The business activity of S consists of the management of its portfolios for the purpose of investing, reinvesting, or trading in stocks and securities. During the taxable year 1968, S has its principal office in the United States within the meaning of paragraph (c)(2)(iii) of § 1.864-2 and, by reason of its trading in the United States in stocks and securities, is engaged in business in the United States. The dividends and interest derived by S during 1968 from sources within the United States, and the

gains and losses from sources within the United States for such year from the sale of stocks and securities from its investment portfolios, are effectively connected for 1968 with the conduct of the business in the United States by that corporation, since its activities in connection with the management of its investment portfolios are activities of that business and such activities are a material factor in the realization of such income, gains, and losses.

Example 2. N, a foreign corporation which uses the calendar year as the taxable year, has a branch in the United States which acts as an importer and distributor of merchandise; by reason of the activities of that branch, N is engaged in business in the United States during 1968. N also carries on a business in which it licenses patents to unrelated persons in the United States for use in the United States. The businesses of the licensees in which these patents are used have no direct relationship to the business carried on in N's branch in the United States, although the merchandise marketed by the branch is similar in type to that manufactured under the patents. The negotiations and other activities leading up to the consummation of these licenses are conducted by employees of N who are not connected with the U.S. branch of that corporation, and the U.S. branch does not otherwise participate in arranging for the licenses. Royalties received by N during 1968 from these licenses are not effectively connected for that year with the conduct of its business in the United States because the activities of that business are not a material factor in the realization of such income.

(4) *Method of accounting as a factor.* In applying the asset-use test or the business-activities test described in subparagraph (1) of this paragraph, due regard shall be given to whether or not the asset, or the income, gain, or loss, is accounted for through the trade or business conducted in the United States, that is, whether or not the asset, or the income, gain, or loss, is carried on books of account separately kept for that trade or business, but this accounting test shall not by itself be controlling. In applying this subparagraph, consideration shall be given to whether the accounting treatment of an item reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business and whether there is a consistent accounting treatment of that

item from year to year by the taxpayer.

(5) *Special rules relating to banking, financing, or similar business activity*—(i) *Definition of banking, financing, or similar business.* A nonresident alien individual or a foreign corporation shall be considered for purposes of this section and paragraph (b)(2) of § 1.864-5 to be engaged in the active conduct of a banking, financing, or similar business in the United States if at some time during the taxable year the taxpayer is engaged in business in the United States and the activities of such business consist of any one or more of the following activities carried on, in whole or in part, in the United States in transactions with persons situated within or without the United States:

- (a) Receiving deposits of funds from the public,
- (b) Making personal, mortgage, industrial, or other loans to the public,
- (c) Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness,
- (d) Issuing letters of credit to the public and negotiating drafts drawn thereunder,
- (e) Providing trust services for the public, or
- (f) Financing foreign exchange transactions for the public.

Although the fact that the taxpayer is subjected to the banking and credit laws of a foreign country shall be taken into account in determining whether he is engaged in the active conduct of a banking, financing, or similar business, the character of the business actually carried on during the taxable year in the United States shall determine whether the taxpayer is actively conducting a banking, financing, or similar business in the United States. A foreign corporation which acts merely as a financing vehicle for borrowing funds for its parent corporation or any other person who would be a related person within the meaning of section 954(d)(3) if such foreign corporation were a controlled foreign corporation shall not be considered to be engaged in the active conduct of a banking, financing, or similar business in the United States.

(ii) *Effective connection of income from stocks or securities with active conduct of a banking, financing, or similar business.* Notwithstanding the rules in subparagraphs (2) and (3) of this paragraph with respect to the asset-use test and the business-activities test, any dividends or interest from stocks or securities, or any gain or loss from the sale or exchange of stocks or securities which are capital assets, which is from sources within the United States and derived by a nonresident alien individual or a foreign corporation in the active conduct during the taxable year of a banking, financing, or similar business in the United States shall be treated as effectively connected for such year with the conduct of that business only if the stocks or securities giving rise to such income, gain, or loss are attributable to the U.S. office through which such business is carried on and—

- (a) Were acquired—
 - (1) As a result of, or in the course of making loans to the public,
 - (2) In the course of distributing such stocks or securities to the public, or
 - (3) For the purpose of being used to satisfy the reserve requirements, or other requirements similar to reserve requirements, established by a duly constituted banking authority in the United States, or
- (b) Consist of securities (as defined in subdivision (v) of this subparagraph) which are—
 - (1) Payable on demand or at a fixed maturity date not exceeding 1 year from the date of acquisition,
 - (2) Issued by the United States, or any agency or instrumentality thereof, or
 - (3) Not described in (a) or in (1) or (2) of this (b).

However, the amount of interest from securities described in (b)(3) of this subdivision (ii) which shall be treated as effectively connected for the taxable year with the active conduct of a banking, financing, or similar business in the United States shall be an amount (but not in excess of the entire interest for the taxable year from sources within the United States from such securities) determined by multiplying the entire interest for the taxable year from sources within the United States from

such securities by a fraction the numerator of which is 10 percent and the denominator of which is the same percentage, determined on the basis of a monthly average for the taxable year, as the book value of the total of such securities held by the U.S. office through which such business is carried on bears to the book value of the total assets of such office. The amount of gain or loss, if any, for the taxable year from the sale or exchange of such securities which shall be treated as effectively connected for the taxable year with the active conduct of a banking, financing, or similar business in the United States shall be an amount (but not in excess of the entire gain or loss for the taxable year from sources within the United States from the sale or exchange of such securities) determined by multiplying the entire gain or loss for the taxable year from sources within the United States from the sale or exchange of such securities by the fraction described in the immediately preceding sentence. The percentage of the denominator of the limiting fraction for such purposes shall be the percentage obtained by separately adding the book value of such securities and such total assets held at the close of each month in the taxable year, dividing each such sum by 12, and then dividing the amount of securities so obtained by the amount of assets so obtained. This subdivision does not apply to dividends from stock owned by a foreign corporation in a domestic corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by such foreign corporation and which is engaged in the active conduct of a banking business in the United States. The application of this subdivision may be illustrated by the following example:

Example. Foreign corporation M, created under the laws of foreign country Y, has in the United States a branch, B, which during the taxable year is engaged in the active conduct of the banking business in the United States within the meaning of subdivision (i) of this subparagraph. During the taxable year M derives from sources within the United States through the activities carried on through B, \$7,500,000 interest from securities described in subdivision (b)(3) of this subdivision (ii) and \$7,500,000 gain from the

sale or exchange of such securities. The monthly average, determined as of the last day of each month in the taxable year, of such securities held by B divided by the monthly average, as so determined, of the total assets held by B equals 15 percent. Under this subdivision, the amount of interest income from such securities that shall be treated as effectively connected for the taxable year with the active conduct by M of a banking business in the United States is \$5 million ($\$7,500,000 \text{ interest} \times 10\% / 15\%$), and the amount of gain from the sale or exchange of such securities that shall be treated as effectively connected for such year with the active conduct of such business is \$5 million ($\$7,500,000 \text{ gain} \times 10\% / 15\%$).

(iii) *Stocks or securities attributable to U.S. office—(a) In general.* For purposes of paragraph (c)(5)(ii) of this section, a stock or security shall be deemed to be attributable to a U.S. office only if such office actively and materially participated in soliciting, negotiating, or performing other activities required to arrange the acquisition of the stock or security. The U.S. office need not have been the only active participant in arranging the acquisition of the stock or security.

(b) *Exceptions.* A stock or security shall not be deemed to be attributable to a U.S. office merely because such office conducts one or more of the following activities:

(1) Collects or accounts for the dividends, interest, gain, or loss from such stock or security,

(2) Exercises general supervision over the activities of the persons directly responsible for carrying on the activities described in paragraph (c)(5)(iii)(a) of this section,

(3) Performs merely clerical functions incident to the acquisition of such stock or security,

(4) Exercises final approval over the execution of the acquisition of such stock or security, or

(5) Holds such stock or security in the United States or records such stock or security on its books or records as having been acquired by such office or for its account.

(c) *Effective date.* This paragraph (c)(5)(iii) shall be effective for income includible in taxable years beginning on or after June 18, 1984, except that 26 CFR 1.864-4 (c)(5)(iii) as it appeared in the Code of Federal Regulations revised as of April 1, 1983, shall apply to

income received or accrued under a loan made by the taxpayer on or before May 18, 1984, or pursuant to a written binding commitment entered into on or before May 18, 1984.

(iv) *Acquisitions in course of making loans to the public.* For purposes of subdivision (ii) of this subparagraph—

(a) A stock or security shall be considered to have been acquired in the course of making a loan to the public where, for example, such stock or security was acquired as additional consideration for the making of the loan,

(b) A stock or security shall be considered to have been acquired as a result of making a loan to the public if, for example, such stock or security was acquired by foreclosure upon a bona fide default of the loan and is held as an ordinary and necessary incident to the active conduct of the banking, financing, or similar business in the United States, and

(c) A stock or security acquired on a stock exchange or organized over-the-counter market shall be considered not to have been acquired as a result of, or in the course of, making loans to the public.

(v) *Security defined.* For purposes of this subparagraph, a security is any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items.

(vi) *Limitations on application of subparagraph—(a) Other business activity.* This subparagraph provides rules for determining when certain income from stocks or securities is effectively connected with the active conduct of a banking, financing, or similar business in the United States. Any dividends, interest, gain, or loss from sources within the United States which by reason of the application of subdivision (ii) of this subparagraph is not effectively connected with the active conduct by a nonresident alien individual or a foreign corporation of a banking, financing, or similar business in the United States may be effectively connected for the taxable year, under subparagraph (2) or (3) of this paragraph with the conduct by such taxpayer of another trade or business in the United States, such as, for example, the busi-

ness of selling or manufacturing goods or merchandise or of trading in stocks or securities for the taxpayer's own account.

(b) *Other income.* For rules relating to income, gain, or loss from sources within the United States (other than dividends or interest from, or gain or loss from the sale or exchange of, stocks or securities referred to in subdivision (ii) of this subparagraph) derived in the active conduct of a banking, financing, or similar business in the United States, see subparagraphs (2) and (3) of this paragraph and paragraph (b) of this section.

(vii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example 1. Foreign corporation F, which is created under the laws of foreign country X and engaged in the active conduct of the banking business in country X and a number of other foreign countries, has in the United States a branch, B, which during the taxable year is engaged in the active conduct of the banking business in the United States within the meaning of subdivision (i) of this subparagraph. In the course of its banking business in foreign countries, F receives at its branches located in country X and other foreign countries substantial deposits in U.S. dollars which are transferred to the accounts of B in the United States. During the taxable year, B actively participates in negotiating loans to residents of the United States, such as call loans to U.S. brokers, which are financed from the U.S. dollar deposits transferred to B by F. In addition, B actively participates in purchasing on the New York Stock Exchange and over-the-counter markets long-term bonds and notes issued by the U.S. Government, U.S. Treasury bills, and long-term interest-bearing bonds issued by domestic corporations and having a maturity date of less than 1 year from the date of acquisition, all of which are purchased from the deposits transferred to B by F. All of the securities so acquired are held by B and recorded on its books in the United States. Pursuant to subdivision (ii) of this subparagraph, the interest received by F during the taxable year on these loans, bonds, notes, and bills is effectively connected for such year with the active conduct by F of a banking business in the United States.

Example 2. The facts are the same as in example 1 except that B also actively participates in using part of the U.S. dollar deposits, which are transferred to it by F, to purchase on the New York Stock Exchange shares of common stock issued by various domestic corporations. All of the shares so purchased are considered to be capital assets

within the meaning of section 1221 and are recorded on B's books in the United States. None of the shares so purchased were acquired for the purpose of meeting reserve or other similar requirements. During the taxable year some of the shares are sold by B on the stock exchange. Pursuant to subdivision (ii) of this subparagraph, the dividends and gains received by F during the taxable year on these shares of stock are not effectively connected with the active conduct by F of a banking, financing, or similar business in the United States.

Example 3. The facts are the same as in example 1 except that B also uses part of the U.S. dollar deposits, which are transferred to it by F, to make a loan to domestic corporation M. As part of the consideration for the loan, M gives to B a number of shares of common stock issued by M. All of these shares of stock are considered to be capital assets within the meaning of section 1221 and are recorded on B's books in the United States. During the taxable year one-half of these shares of stock is sold by B on the New York Stock Exchange. Pursuant to subdivision (ii) of this subparagraph, the dividends and gains received by F during the taxable year on these shares of stock are effectively connected for such year with the active conduct by F of a banking business in the United States.

Example 4. The facts are the same as in example 1 except that during the taxable year the home office of F in country X actively participates in negotiating loans to residents of the United States, such as call loans to U.S. brokers, which are financed by the U.S. dollar deposits received at the home office and are recorded on the books of the home office. B does not participate in negotiating these loans. Pursuant to subdivision (ii) of this subparagraph the interest received by F during the taxable year on these loans made by the home office in country X is not effectively connected with the active conduct by F of a banking, financing, or similar business in the United States.

Example 5. Foreign corporation Y, which is created under the laws of foreign country X and is engaged in the active conduct of a banking business in country X and other foreign countries, has a branch, C, in the United States that is engaged in the active conduct of a banking business in the United States, within the meaning of paragraph (c)(5)(i) of this section, during the taxable year. C handles the negotiation and acquisition of securities involved in loans made by Y to U.S. persons. C also presents interest coupons with respect to such securities for payment, presents all such securities for payment at maturity, and maintains compete photocopy files with respect to such securities. The activities of the office of Y in country X with respect to these securities consist of giving pro forma approval of the loans, storing the

original securities, and recording the securities on the books of the country X office. Pursuant to paragraphs (c)(5)(ii) and (c)(5)(iii) of this section, the U.S. source interest income received by Y during the taxable year on these securities is effectively connected for such year with the active conduct by Y of a banking business in the United States.

(6) *Income related to personal services of an individual*—(i) *Income, gain, or loss from assets.* Income or gains from sources within the United States described in section 871(a)(1) and derived from an asset, and gain or loss from sources within the United States from the sale or exchange of capital assets, realized by a nonresident alien individual engaged in a trade or business in the United States during the taxable year solely by reason of his performing personal services in the United States shall not be treated as income, gain, or loss which is effectively connected for the taxable year with the conduct of a trade or business in the United States, unless there is a direct economic relationship between his holding of the asset from which the income, gain, or loss results and his trade or business of performing the personal services.

(ii) *Wages, salaries, and pensions.* Wages, salaries, fees, compensations, emoluments, or other remunerations, including bonuses, received by a nonresident alien individual for performing personal services in the United States which, under paragraph (a) of § 1.864-2, constitute engaging in a trade or business in the United States, and pensions and retirement pay attributable to such personal services, constitute income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual if he is engaged in a trade or business in the United States at some time during the taxable year in which such income is received.

(7) *Effective date.* Paragraphs (c)(2) and (c)(6)(i) of this section are effective for taxable years beginning on or after June 6, 1996.

[T.D. 7216, 37 FR 23425, Nov. 3, 1972, as amended by T.D. 7332, 39 FR 44232, Dec. 23, 1974; T.D. 79-58, 49 FR 21052, May 18, 1984; T.D. 8657, 61 FR 9337, Mar. 8, 1996; T.D. 9226, 70 FR 57510, Oct. 3, 2005]